

Example 5. A, an individual, is liable for an addition to tax under section 6654 for the underpayment of estimated tax from April 15, 1975 until January 15, 1976. The addition to tax shall be computed at the annual rate of 6 percent per annum from April 15, 1975, to June 30, 1975, and at the annual rate of 9 percent per annum from June 30, 1975, to January 15, 1976.

Example 6. B, an individual, files an income tax return for calendar year 1980 on April 15, 1981, showing a tax due of \$1,000. B pays the \$1,000 on March 1, 1983. Under section 6601 (a), interest on the \$1,000 underpayment is due from April 15, 1981, to March 1, 1983. Such interest is computed at the rate of 12 percent per annum, simple interest from April 15, 1981, to January 31, 1982, and at the rate of 20 percent per annum, simple interest from January 31, 1982, to December 31, 1982, and at the rate of 16 percent per annum, compounded daily, from December 31, 1982, to March 1, 1983. The total simple interest accrued but unpaid at the end of December 31, 1982, is combined with the \$1,000 underpayment for purposes of determining the amount of daily compounded interest to be charged from December 31, 1982, to March 1, 1983.

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§ 301.6621-2T Questions and answers relating to the increased rate of interest on substantial underpayments attributable to certain tax motivated transactions (temporary).

The following questions and answers relate to the increased rate of interest on substantial underpayments attributable to certain tax motivated transactions as provided in section 6621(d) of the Internal Revenue Code of 1954, as added by section 144 of the Tax Reform Act of 1984 (Pub. L. 98-369, 98 Stat. 682):

Q-1. What is the annual interest rate under section 6621 for purposes of computing the amount of interest that must be paid under section 6601 (relating to interest on underpayments)?

A-1. In general, the annual interest rate for purposes of section 6601 is the adjusted rate of interest established under section 6621 (b) § 301.6621-1 (“adjusted rate”). If, however, a tax motivated underpayment (as defined in A-2 of this section) for a taxable year is substantial (as defined in A-7 of this section), section 6621(d) provides that the annual rate of interest with respect to the tax motivated underpayment is 120 percent of the adjusted rate (“120

percent rate”), rounded to the nearest tenth of a percent.

Q-2. What is a tax motivated underpayment?

A-2. A tax motivated underpayment is the portion of a deficiency (as defined in section 6211) of tax imposed by subtitle A (income taxes) that is attributable to any of the following tax motivated transactions:

(1) Any instance in which the value of any property, or the adjusted basis of any property, claimed on a return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (*i.e.*, a valuation overstatement within the meaning of section 6659(c)(1));

(2) Any loss disallowed for any period by reason of section 465(a) or any amount included in gross income by reason of section 465(e);

(3) Any credit disallowed for any period by reason of section 46(c)(8) or section 48(d)(6);

(4) Any loss disallowed for any period with respect to a straddle, as defined in section 1092(c), but without regard to sections 1092 (d) and (e);

(5) Any use of an accounting method that may result in a substantial distortion of income for any period (see A-3 of this section); and

(6) Any deduction disallowed with respect to any other tax motivated transactions (see A-4 of this section).

Q-3. What accounting methods may result in a substantial distortion of income for any period under A-2(5) of this section?

A-3. A deduction or credit disallowed, or income included, in any of the circumstances listed below shall be treated as attributable to the use of an accounting method that may result in a substantial distortion of income and shall thus be a tax motivated transaction that results in a tax motivated underpayment:

(1) Any deduction disallowed for any period by reason of section 464 or section 278(b), relating to certain expenses of farming syndicates;

(2) In the case of a taxpayer who computes taxable income using the

cash receipts and disbursements method of accounting, any interest deduction disallowed for any period by reason of section 461(g), relating to prepaid interest, provided the interest is not paid with respect to indebtedness incurred in connection with (i) the purchase, refinancing, or improvement of the principal residence of the taxpayer, or (ii) the purchase of consumer goods by the taxpayer;

(3) Any interest deduction disallowed for any period because the amount of the claimed deduction was computed using a method resulting in an amount of interest for a period that exceeds the true cost of the indebtedness for the period computed by applying the effective rate of interest on the loan to the unpaid balance of the loan for the period (*i.e.*, the economic accrual of interest is not accrued with respect to indebtedness incurred in connection with (i) the purchase, refinancing, or improvement of the principal residence of the taxpayer, or (ii) the purchase of consumer goods by the taxpayer (see Rev. Rul. 83-84, 1983-1 C.B. 97, and sections 163(e), 446(b), and 483);

(4) Any deduction disallowed for any period under section 709, relating to organization or syndication expenditures of a partnership;

(5) In the case of any expenditure described in section 248(b) that was incurred by an S corporation, any deduction disallowed because it exceeds the amount allowable under section 248, relating to organizational expenditures;

(6) Any deduction disallowed for any period under section 267(a), relating to transactions between related taxpayers;

(7) Any deduction disallowed for any period, or any income required to be included for any period, under section 467, relating to certain payments for the use of property or services;

(8) Any deduction disallowed for any period under section 461(i), relating to certain deductions of tax shelters; and

(9) In the case of a taxpayer who computes taxable income using the cash receipts and disbursements method of accounting, any deduction disallowed for any period because (i) the expenditure resulting in the deduction was a deposit rather than a payment,

(ii) the expenditure was prepaid for tax avoidance purposes and not for a business purpose, or (iii) the deduction resulted in a material distortion of income (see, *e.g.*, Rev. Rul. 79-229, 1979-2 C.B. 210).

Q-4. Are any transaction other than those specified in A-2 of this section and those involving the use of accounting methods under circumstances specified in A-3 of this section considered tax motivated transactions under A-2(6) of this section?

A-4. Yes. Deductions disallowed under the following provisions are considered to be attributable to tax motivated transactions:

(1) Any deduction disallowed for any period under section 183, relating to an activity engaged in by an individual or an S corporation that is not engaged in for profit, and

(2) Any deduction disallowed for any period under section 165(c)(2), relating to any transaction not entered into for profit.

Q-5. How is the amount of a tax motivated underpayment determined?

A-5. Except as provided in A-6 of this section, the amount of a tax motivated underpayment is determined in the following manner:

(1) Calculate the amount of the tax liability for the taxable year as if all items of income, gain, loss, deduction, or credit, had been reported properly on the income tax return of the taxpayer ("total tax liability"); and

(2) Without taking into account any adjustments to items of income, gain, loss, deduction, or credit that are attributable to tax motivated transactions (as defined in A-2 through A-4 of this section), calculate the amount of the tax liability for the taxable year as if all other items of income, gain, loss, deduction, or credit had been reported properly on the income tax return of the taxpayer ("tax liability without regard to tax motivated transactions").

(3) The difference between the total tax liability and the tax liability without regard to tax motivated transactions is the amount of the tax motivated underpayment.

Example. Taxpayer A, a calendar year taxpayer, files his 1984 income tax return reporting \$70,000 of taxable income and \$23,171

of tax liability. On January 20, 1986, A enters into a closing agreement with the Internal Revenue Service that includes the following adjustments;

Section 162 deduction disallowed (not tax motivated)	\$7,500
Loss disallowed under section 465 (tax motivated—see A-2(2) of this section)	5,000
Section 170 deduction disallowed because of a valuation overstatement (tax motivated—see A-2(1) of this section)	10,000
Loss disallowed with respect to a straddle as defined in section 1092(c) (tax motivated—see A-2(4) of this section)	7,000
Other adjustments (none of which are tax motivated)	4,000
1. Reported taxable income	70,000
(Add all adjustments to items of income, gain, loss, deduction, or credit (including tax motivated transactions subject to section 6621(d)))	
	+33,500
Tax=\$39,685 ("total tax liability")	103,500
2. Reported taxable income	70,000
(Add adjustments to items of income, gain, loss, deduction, or credit other than those with respect to items that are tax motivated)	
	+11,500
Tax=\$28,691 ("tax liability without regard to tax motivated transactions")	81,500

The tax motivated underpayment (i.e., the underpayment attributable to tax motivated transactions) is \$10,994 (\$39,685 – \$28,691). Accordingly, the interest on \$10,994 would be computed at the 120 percent rate.

The remainder of the underpayment (i.e., the underpayment not attributable to tax motivated transactions) is \$5,520 (\$28,691 (tax liability without regard to tax motivated items) – \$23,171 (tax paid with return)). The interest on \$5,520 would be computed at the adjusted rate.

Q-6: How are the amounts of the tax motivated underpayment and the underpayment attributable to fraud or negligence determined if all or a portion of the taxpayer's underpayment is attributable to one or more tax motivated transactions and all or a portion is subject to the addition to tax imposed by section 6653(a)(2) (in the case of an underpayment attributable to negligence or intentional disregard) or section 6653(b)(2) (in the case of an underpayment attributable to fraud)?

A-6: If all or a portion of the taxpayer's underpayment is attributable to tax motivated transactions, and all or a portion is attributable to fraudulent or negligent items (i.e., items that result in an underpayment subject to the addition to tax imposed by section 6653 (a)(2) or (b)(2)), the amount of the tax motivated underpayment and the

underpayment attributable to fraud or negligence is determined in the following manner:

(1) Determine the following amounts;

(i) The tax liability for the taxable year of the taxpayer as if all items of income, gain, loss, deduction, or credit had been reported properly on the income tax return of the taxpayer ("total tax liability");

(ii) The tax liability for the taxable year of the taxpayer as if all items of income, gain, loss, deduction, or credit without taking into account adjustments to items of income, gain, loss, deduction, or credit that are both (a) attributable to tax motivated transactions and (b) subject to section 6653(a)(2) or section 6653(b)(2), had been reported properly on the income tax return of the taxpayer ("tax liability without regard to fraudulent or negligent tax motivated items");

(iii) The tax liability for the taxable year of the taxpayer as if all items of income, gain, loss, deduction, or credit, without taking into account adjustments to items of income, gain, loss, deduction, or credit that are subject to section 6653(a)(2) or section 6653(b)(2), had been reported properly on the income tax return of the taxpayer ("tax liability without regard to fraudulent or negligent items");

(iv) The tax liability for the taxable year of the taxpayer as if all items of income, gain, loss, deduction, or credit, without taking into account adjustments to items of income, gain, loss, deduction, or credit that are either subject to section 6653(a)(2) or section 6653(b)(2) or attributable to tax motivated transactions, had been reported properly on the income tax return of the taxpayer ("tax liability without regard to tax motivated or fraudulent or negligent items").

(2) The tax motivated underpayment attributable to fraudulent or negligent items is the excess of the total tax liability over the tax liability determined without regard to fraudulent or negligent tax motivated items ((i)–(ii)).

(3) The tax motivated underpayment is the sum of (a) the tax motivated underpayment attributable to fraudulent or negligent items ((i)–(ii)) plus (b) the excess of the tax liability without regard to fraudulent or negligent items

over the tax liability without regard to tax motivated or fraudulent or negligent items ((iii)-(iv)). Interest on this underpayment is computed at the 120 percent rate.

(4) The underpayment attributable to fraudulent or negligent items is the excess of the total tax liability over the tax liability without regard to fraudulent or negligent items ((i)-(iii)). The section 6653 addition to tax is 50 percent of the interest on this underpayment computed at the 120 percent rate on an amount equal to the tax motivated underpayment attributable to fraudulent or negligent items (computed in (2)) and at the adjusted rate on the remainder.

Example. Taxpayer A, a calendar year taxpayer, files his 1984 income tax return reporting \$70,000 of taxable income and \$23,171 of tax liability. On January 20, 1986, A enters into a closing agreement with the Internal Revenue Service that includes the following adjustments:

Section 162 deduction disallowed (not tax motivated but fraudulent or negligent)	\$7,500
Loss disallowed under section 465(a) (tax motivated—see A-2(2) of this section—and fraudulent or negligent)	5,000
Section 170 deduction disallowed because of a valuation overstatement (tax motivated—see A-2(1) of this section—but not fraudulent or negligent)	10,000
Loss disallowed with respect to a straddle as defined in section 1092(c) (tax motivated—see A-2(4) of this section but not fraudulent or negligent)	7,000
Other adjustments (none of which are tax motivated or fraudulent or negligent)	4,000

The tax motivated underpayment is determined in the following manner:

(1)(i) Reported taxable income	\$70,000
(Add all adjustment	+33,500
Tax=\$39,685 ("total tax liability")	103,500
(ii) Reported taxable income	70,000
All adjustments other than those with respect to items that are both tax motivated and fraudulent or negligent	+28,500
Tax=\$37,185 ("tax liability without regard to fraudulent or negligent, tax motivated items")	98,500
(iii) Reported taxable income	70,000
(All adjustments other than those with respect to items that are fraudulent or negligent)	+21,000
Tax=\$33,435 ("tax liability without regard to fraudulent or negligent items")	91,000
(iv) Reported taxable income	70,000
(All adjustments other than those with respect to items that are either tax motivated or fraudulent or negligent)	+4,000

Tax=\$25,091 ("tax liability without regard to tax motivated or fraudulent or negligent items")	74,000
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(2) The tax motivated underpayment attributable to fraudulent or negligent items is \$2,500 ((i)-(ii) or \$39,685-\$37,185).

(3) The tax motivated underpayment is \$10,844 ((2)+((iii)-(iv)) or \$2,500+(\$33,435-\$25,091)). Interest on \$10,844 is computed at the 120 percent rate.

(4) The underpayment attributable to fraudulent or negligent items is \$6,250 ((i)-(iii) or \$39,685-\$33,435). The section 6653 addition to tax is 50 percent of the interest on \$6,250, computed at the 120 percent rate on an amount equal to the tax motivated underpayment attributable to fraudulent or negligent items (\$2,500) and at the adjusted rate on the remainder (\$3,750).

(5) In summary, therefore, the total underpayment is \$16,514 (total tax liability (\$39,685) less reported tax liability (\$23,171)) of which \$10,844 accrues interest at the 120 percent rate and \$5,670 (\$16,514-\$10,844) accrues interest at the adjusted rate. In addition, \$6,250 of the underpayment is subject to the section 6653(a)(2) or section 6653(b)(2) addition to tax. The underlying interest, upon which the addition to tax is based, is computed using the 120 percent rate for the portion of the underpayment subject to section 6621(d) (\$2,500) and the adjusted rate for the portion that is not subject to section 6621(d) (\$3,750).

Q-7. Does the 120 percent rate apply to all tax motivated underpayments?

A-7. No. The 120 percent rate applies only if the tax motivated underpayment for the taxable year is substantial. A tax motivated underpayment is substantial only if it exceeds \$1,000. If, for example, a taxpayer has a \$600 underpayment attributable to a valuation overstatement (within the meaning of section 6659(c)(1)) and a \$500 underpayment attributable to a loss disallowed under section 465(a), the amount of the tax motivated underpayment is \$1,100. Because the amount of the tax motivated underpayment is thus substantial the 120 percent rate applies.

Q-8. How do carryovers affect the amount of the tax motivated underpayment and the amount of the underpayment attributable to fraudulent or negligent items?

A-8. For purposes of A-5 and A-6 of this section, a net operating loss carryover, capital loss carryover, or credit carryover is treated as a deduction or credit in the year in which taken into account. In any computation of tax liability required under A-5 or A-6 of this section (*i.e.*, total tax liability, tax liability without regard to tax motivated transactions, etc.), the amount of such deduction or credit is the amount of the carryover determined as if the taxpayer had properly reported in each taxable year all items of income, gain, loss, deduction, or credit affecting the amount of the carryover other than adjustments of a type not taken into account in such computation of tax liability. A net operating loss carryback, capital loss carryback, or credit carryback is not taken into account, however, in determining the amount of the tax motivated underpayment or the amount of the underpayment attributable to fraud or negligence for periods before the last date prescribed for filing the income tax return for the taxable year in which the carryback arises (determined without regard to extensions).

Q-9. What amount is subject to the 120 percent rate if the amount of a taxpayer's unpaid tax for a year is less than the taxpayer's substantial tax motivated underpayment?

A-9. The 120 percent rate applies with respect to the lesser of—

(1) The amount of unpaid tax for the taxable year determined in accordance with § 301.6601-1; or

(2) The substantial tax motivated underpayment for the taxable year.

Q-10. What is the effective date for the 120 percent rate?

A-10. The 120 percent rate applies to interest accruing on a deficiency attributable to a substantial tax motivated underpayment after December 31, 1984, including interest accruing with respect to transactions described in A-3 and A-4 of this section, regardless of the date prescribed for payment of the tax.

Example. Taxpayer A files his income tax return on April 15, 1983 (the last date prescribed for payment of tax for taxable year 1982 under section 6601). In January 1985, Taxpayer A files a petition in the Tax Court in response to a statutory notice of deficiency for taxable year 1982, which includes a tax motivated underpayment of \$10,000. In September 1986, the Tax Court enters a decision for the Internal Revenue Service. Under section 6601, interest accrues at the adjusted rate, compounded daily, on tax motivated underpayments outstanding before January 1, 1985, and at the 120 percent rate, compounded daily, on amounts outstanding after December 31, 1984. The underpayment that is subject to the 120 percent rate includes both the \$10,000 tax motivated underpayment and the interest that accrued on the underpayment at the adjusted rate from April 16, 1983, through December 31, 1984.

Q-11. Can a taxpayer stop the running of interest on a tax motivated underpayment by application of a remittance?

A-11. Yes. The running of interest on a tax liability stops on the date the remittance (either a payment of tax or a deposit in the nature of a cash bond) is received by the Internal Revenue Service, regardless of when the liability is assessed or the remittance is actually applied against the taxpayer's account. A taxpayer must make a remittance for both the tax liability and the interest that has accrued as of the date of remittance to stop the running of interest on both the tax liability and the accrued interest with respect to the liability. (See Rev. Proc. 84-58.) Taxpayer cannot make partial remittances applicable only to tax motivated underpayments. Under A-9 of this section, the 120 percent rate applies to the amount of unpaid tax to the extent that amount does not exceed the tax motivated underpayment. Therefore, a partial remittance is applied first to any tax due that is not attributable to a tax motivated underpayment. The excess of the partial remittance over tax that is not attributable to a tax motivated underpayment, if any, will then be applied to tax due that is attributable to a tax motivated underpayment.

Q-12. Does the 120 percent rate apply to interest accruing on interest, penalties, additional amounts, or additions to tax as provided in section 6601(e)(2)?

A-12. The 120 percent rate applies only to taxes imposed by subtitle A (income taxes) and to interest accrued with respect to such taxes. The penalties, additional amounts, and additions to tax specified in section 6601(e)(2) are not imposed by subtitle A and are not, therefore, included in the amount of a tax motivated underpayment. They are, however, included in the amount of unpaid tax for purposes of A-9 of this section.

Example. Taxpayer A, for taxable year 1984, has a \$10,000 tax motivated underpayment and a \$2,000 addition to tax for a total unpaid tax of \$12,000. If A makes a \$5,000 payment of tax, he will still have a \$10,000 tax motivated underpayment but will now have only \$7,000 of unpaid tax. Pursuant to A-9 of this section, therefore, the 120 percent rate would apply to the \$7,000 of unpaid tax.

(Secs. 6621(d) and 7805, Internal Revenue Code of 1954 (98 Stat. 682, 26 U.S.C. 6621(d); 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7998, 49 FR 50391, Dec. 28, 1984]

§ 301.6621-3 Higher interest rate payable on large corporate underpayments.

(a) *In general.* Section 6621 establishes the interest rate for purposes of computing the amount of interest that must be paid under section 6601, relating to interest on underpayments of tax. Section 6621(a)(2) provides that the underpayment rate is the sum of the Federal short-term rate (determined under section 6621(b)) plus 3 percentage points. That underpayment rate is referred to hereinafter as the “section 6621(a)(2) rate.” Section 6621(c) and this section, however, provide that the underpayment rate on any large corporate underpayment is the sum of the Federal short-term rate (determined under section 6621(b)) plus 5 percentage points. This higher underpayment rate is referred to hereinafter as the “section 6621(c) rate.” The section 6621(c) rate applies only for periods after the applicable date (as determined in paragraph (c) of this section).

(b) *Large corporate underpayment—(1) Defined.* For purposes of section 6621(c) and this section, “large corporate underpayment” means any underpayment of a tax by a C corporation for any taxable period if the amount of the threshold underpayment of the tax (as de-

fined in paragraph (b)(2)(ii) of this section) for that taxable period exceeds \$100,000.

(2) *Underpayment of a tax—(i) In general.* As used in section 6621(c) and this section, “underpayment of a tax” means the excess of a tax imposed by the Internal Revenue Code over the amount of such tax paid on or before the last date prescribed for payment. Except as provided in paragraph (b)(2)(ii) of this section, “tax” for such purposes includes interest, penalties, additional amounts, and additions to tax. See sections 6601(e)(1), 6665(a), and 6671(a). Thus, the section 6621(c) rate generally applies to any interest, penalties, additional amounts, and additions to tax, as well as to the underlying tax with respect to which such amounts are imposed.

(ii) *Threshold underpayment of a tax.* Solely for purposes of this section and not for any other purpose under section 6621(c) or elsewhere in the interpretation or administration of the federal tax laws, a “threshold underpayment of a tax” is the excess of a tax imposed by the Internal Revenue Code (exclusive of interest, penalties, additional amounts, and additions to tax) for the taxable period over the amount of such tax paid on or before the last date prescribed for payment. Thus, any payments made after the last date prescribed for payment (for example, by way of an amended return) will not affect the existence of a threshold underpayment. In determining whether there is a threshold underpayment, different types of taxes (such as income tax and FICA tax) and amounts that relate to different taxable periods are not added together.

(iii) *When determined—(A) In general.* The existence of a threshold underpayment of a tax and the amount of a large corporate underpayment are generally determined only when an assessment is made with respect to the taxable period. Thus, the amount of a deficiency or proposed deficiency set forth in a letter or notice pursuant to which the applicable date is determined (under paragraph (c) of this section) does not determine whether there is a large corporate underpayment.

(B) *Judicial determinations.* Notwithstanding any prior assessment made